Rather than viewing rate regulation in its static and most recently pronounced form, utilizing and imposing traditional restrictions and limitations on carriers' pricing and cost recovery would not be sensible given cable's newly acquired regulatory status.[20/] The Commission should review how courts struggled with rate regulation in the early days when industries in their infancy were being first subject to regulation.

In the early days of regulation, courts expressly allowed considerations of "fair value" to guide the setting of rates. For more than fifty years the rule of Smyth v. Ames specified the criteria to determine reasonableness of rates.

> [T]he basis of all calculations as to the reasonableness of rates . . . must be the fair value of the property being used by it for the convenience of the public. And, in order to ascertain that value, the original cost of construction, the amount expended in permanent improvements, the amount and market value of its bonds and stock, the present as compared with the original cost of construction, the probable earning capacity of the property under particular rates prescribed by statute, and the sum required to meet operating expenses, are all matters for consideration, and are to be given such weight as may be just and right in each case.

Smyth v. Ames, 169 U.S. 466, 546-47 (1898). This pronouncement was the law of rate regulation for almost fifty years until the

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20/ For example, the Commission subjects regulated common carriers to a multitude of tariff requirements, depreciation limits, cost allocation manuals and return allowances.

Supreme Court held that "fair value" was not the only constitutionally acceptable method of fixing utility rates. In Hope, 320 U.S. at 605, the Court found that historical cost was also a valid basis in which to calculate utility compensation. Until Hope, the Court uniformly found fair value and utilized going concern value and other intangibles in determining reasonable rates.[21/]

However, approximately half-way through the life of Smyth v. Ames, Justice Brandeis, in a remarkable and celebrated concurrence in Missouri ex rel. Southwestern Bell Tel. Co. v. Public Serv. Comm'n, 262 U.S. 276, 292-94 (1923),[22/] argued that the amount of "prudent investment" better reflected the measure of the compensatory rate necessary to survive constitutional review. Justice Brandeis nonetheless recognized that goodwill, franchise value and other intangibles have value in condemnation cases (and indeed are often more valuable than tangible property), but believed that were too many practical problems associated with "the laborious and baffling task of finding the present value of the utility." Id. at 292-94.[23/]

21/ See, e.g., Los Angeles Gas & Elec. Corp. v. Railroad Comm'n, 289 U.S. 287, 313 (1933).

22/ Justice Brandeis' opinion is often characterized as a "dissent" because he differed "fundamentally from his brethren concerning the rule to be applied in determining whether a prescribed rate is confiscatory." Id. at 289.

23/ The major problem with "fair value" was the impossibility of determining market prices because utility assets were rarely

[Footnote continued]

Although Justice Brandeis essentially accepted the "eminent domain" analogy to determine value, he focused more on prudent investment as the appropriate measure than the value of the assets or business. While the logic of Justice Brandeis' concurrence in the Southwestern Bell decision arguably led -- twenty years later -- to the abandonment of the "fair value" concept as the only means of evaluating utility rates, the unique circumstances of the cable industry's entry into regulation create a situation where fair value now is an appropriate transitional consideration in determining whether a cable operator's rate indeed is reasonable.

Historically, "fair value" was an important concept when the regulation of an industry was in its infancy, and is important now given the state of the cable industry and movement into regulation. The importance of fair value considerations in the time before Hope was exemplified in the court of appeals' decision reversed by the Supreme Court in that case. In the decision, the appeals court noted that the "newness" of the industry, uncertainty of customers and business, as well as the

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[Footnote continued]

bought and sold. Duquesne Light Co., 488 U.S. at 309. However, cable systems in the 1980's, not being regulated utilities, were routinely bought and sold in a competitive market, thus providing an accurate basis for determining "fair value." See Exhibit C.

difficult engineering problems, all were relevant considerations requiring an analysis of more than the costs committed to the tangible assets.

> The losses of the first years supplied persuasive evidence that the investment was highly speculative and an adequate return on the capital invested depended largely upon the business acumen, the engineering skill, and administrative efficiency of their officers, to overcome these losses and develop a profit in this newly regulated industry. Under such circumstances it seems that fairness necessitates the capitalization and inclusion of such skill -- aye, and hazards -- as legitimately as the cost of pipes . . . It was the courage of the investors, and their willingness to take a chance in a speculative venture, the vision to see and to forecast, the integrity of management . . . which gave to the enterprise its life; and the product of these combined factors made for a going value, which, in the realities of the business world, is justly recognized as part of the value of the investment. *It is the existing fact situation peculiar to this case which calls loudly for the inclusion of a sum for going value, as such.* Nor can we fairly apply the law, save as we first study the facts and get the proper setting of the natural gas industry in the utility field.

Natural Gas Pipeline Co. v. F.P.C., 120 F.2d 625, 635 (7th Cir. 1941)(emphasis added), rev'd, F.P.C. v. Natural Gas Pipeline Co., 315 U.S. 575 (1942).

Indeed, "fair value" had been the only method of assessing the amount of capital invested in the regulated enterprise. Even Justice Brandeis recognized that in the early stages of regulation for an industry, concepts such as "original cost,"

"capital charges" and the like were difficult to determine in assessing the adequacy of rates.

> Twenty-five years ago, when Smyth v. Ames was decided, it was impossible to ascertain with accuracy, in respect to most of the utilities, in most of the states in which rate controversies arose, what it cost in money to establish the utility, or what the money cost with which the utility established, or what income had been earned by it, or how the income had been expended. It was therefore, not feasible then to adopt, as the rate base, the amount properly invested, or, as the rate of fair return, the amount of the capital charge.

Southwestern Bell, 262 U.S. at 309.

Upon maturity, the rules of regulatory ratesetting changed to reflect advances in accounting and development of the regulated industries. The cable industry now, however, reflects many of the problems noted by Justice Brandeis at the advent of regulation, especially the difficulty of determining "original cost,"[24/] and deciphering, through various layers of financing and acquisitions, what the actual costs and capital investment are or even value of the assets acquired or constructed initially.[25/] And courts have always noted that depreciated book

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24/ See § III(E)(2) infra.

25/ Cable operators have utilized differing accounting methods and expensed, rather than capitalized many items. From an industry standpoint, the existing tangible book value would be unrepresentative of the ratebase needed to reflect the amount of invested capital.

value of assets in no way reflects a "fair value" by itself.[26/] Indeed, the "fair value" of even long regulated utilities typically exceeds book value by a significant factor. See, infra at § III(B).

In order to account for the interests of the industry and the terms of the 1992 Cable Act, the Commission must allow for transition in ratesetting to reflect expenses incurred in prior years and assets bought and paid for prior to regulation. The Commission should allow "acquisition costs" to be recoverable with a one-time adjustment to the ratebase, and a recovery of non-ratebase costs through amortization. The Commission had suggested that these acquisition costs could be recovered in their entirety as a transitional measure. NPRM at ¶ 40. These or a portion of the acquisition costs should be maintained in the ratebase as well as to reflect the entry of property into regulated service.

The Commission should also allow a valuation of intangibles, as more fully described below to account for the inherent

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26/ "Good-will and going concern value may have great value and yet not be reflected by the books at all. The same is true of easements, water rights, patents and similar intangible property rights. But their inclusion in the book accounts at a certain value is little, if any evidence of their true value, and their omission from the books does not estop the owner from claiming that which actually exists." Eastbay Water Co. v. McLaughlin, 24 F. Supp. 222, 227 (N.D. Cal. 1938).

value in systems "built and held" to determine a reasonable ratebase properly reflecting the substantial value intangibles provide. "Going concern value" is an appropriate measure of the intangible assets acquired and of significant value to the cable operators for which recovery is appropriate. Intangibles may be subdivided into components, all of which have a substantial and independently significant value. These concepts are more fully discussed below should be incorporated as transitional devices to ease the change from deregulation to regulation while preparing for the expected return to deregulation.

III. DETERMINING THE APPROPRIATE RATEBASE REQUIRES RECOGNITION OF CAPITAL EXPENDITURES REASONABLY MADE IN THE UNREGULATED ENVIRONMENT

Setting the ratebase for cable television is an undertaking so challenging and so fraught with peril -- both to the financial integrity of the cable industry and to the Commission's regulatory processes -- that the decisions must be tested against several primary principles.

A. Cable System Purchases Were Made In Competitive Markets

First, in defining principle, rate regulation is intended as a surrogate for competitive pricing where the regulated entity operates as a statutory monopoly. This principle, often repeated as the basis for utility regulation, is codified in the findings of Congress and endorsed repeatedly by

commentators.[27/] Importantly, rate regulation is not intended to be punitive. Thus, rate base valuation should comport with physical asset and cash flow multiples found in the valuation of firms that operate in effectively competitive markets and are not regulated. Even before the 1984 Cable Act, cable operators' investment decisions were not based on regulatory "revenue requirements", and certainly during the non-rate regulation periods no biases related to rate regulation were reflected in cable industry financial or operating practices. Instead, cable operators' capital investment and recovery decisions reflected the same factors that affect competitive industries, including technological and financial conditions, as well as by unique circumstances such as limited duration of cable franchises. AUS Report at 33-51.

Making cable's ratebase reflective of costs and capital invested will establish cable rate regulation on the proper constitutional footing -- assurance of an adequate return on invested capital -- and satisfy the policy to preserve the cable operator's ability to attract investment capital needed to maintain the firm and to improve plant in an increasingly competitive environment. Rate regulation is structurally premised as a transition to a competitive market, which the rest of the Act, and many actions by the FCC, are intended to promote. If cable

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27/ See text accompanying footnote 6, supra.

television is transitioning into a competitive environment, it is crucial to preserve its ability to attract capital now to meet that competition in the future.

B. Competitive Firms Are Routinely Purchased At Significant Multiples Of Book Value

It would be contrary to the business realities of the cable television industry for the Commission to refuse to recognize in rate base the acquisition costs paid in connection with some cable system acquisitions. First, the industry groups considered "comparable" to cable operators in the NPRM -- such as the Standard & Poor's 400 Industrials[28/] -- routinely trade at more than three times book value. This high "mark-up" over the physical value of these firms' assets occurs even though there has been no suggestion that, on average, the firms making up that group are earning "monopoly" profits on their operations.[29/] This fact shows that the basic premise underlying the tentative conclusion that "excess" acquisition costs should be disallowed from rate base -- the concern that they might represent an expectation of monopoly revenues -- is empirically erroneous as a factual matter and should be rejected.

28/ NPRM ¶ 50.

29/ Businesses are conventionally valued for more than the net book value of tangible assets. Real estate ventures are valued on cash flow, but none can seriously maintain that commercial office buildings command monopoly rents.

For example, the Sprint and Centel merger agreement in 1992 was valued at $2.85 billion Telecommunications Reports, June 1, 1992, at 13, but on the date it was announced the approximate market value of Centel (the acquired company) was $3.6 billion, although its net plant rate base was only $1.6 billion FCC Statistics of Common Carriers, 1991, Table 2.9, line 350, and its assets were only $1.86 billion Id., line 360. Thus, notwithstanding even the higher market valuation of the Centel (most of whose assets are subject to rate regulation), the merger occurred at a multiple 1.5-time assets and nearly 1.8-times the rate base subject to federal and state regulation.

Similarly, the GTE/Contel merger in 1990 was valued at $6.2 billion, Telecommunications Reports, July 16, 1990, at 1. In 1990, the reported net plant rate base for the Contel telephone companies was $2.19 billion, FCC Statistics of Common Carriers, 1990, Table 2.9, line 350. The sale thus occurred at 2.8-times the regulated rate base and 2.4-times reported assets.30/

30/ Contel's book value was reported at the announced date of the merger as $10.54 per share. At the acquisition price of $39.37 per share, price was a multiple of almost four times book value. In total figures, Contel, with a net worth of slightly less than $1.7 billion "on the books" was acquired for $6.2 billion. Investment Dealers Digest Information Services Inc., Mergers and Acquisitions Database (1990).

Finally, Pacific Telecom's purchase of Anchorage Telephone Utility in 1989 was priced at $412 million. ATU's total assets were $299 million, so the acquisition price was at a 1.38 multiple over assets. ATU's operating revenues when it was purchased were $81 million; the acquisition multiple to revenues 5.1 times, Telecommunications Reports, August 28, 1989.

In each of these instances, the acquisition price of the firm, each one predominantly engaged in providing regulated telephone services, reflected a significant multiple over the regulated assets. Thus, if regulation is assumed to be at all effective in curbing monopoly power, the acquisition price multiples did not represent an "excess" but rather an economic source of value. Cable assets inserted into rate base regulation for the first time likewise contain legitimate sources of economic value in excess of the depreciated value of "hard" plant assets.[31/]

Objective market valuations reflect an understanding that the value of a firm as a going concern, plus the value of a firm positioned to participate in future telecommunications ventures, is greater than the depreciated book price of its assets.

31/ Cable system and other acquisitions studied by AUS show a range of 20 to 27.5 market-to-book ratios. AUS Report at 27-29. Reported cable acquistion ratios are well within this range and consistent with ratios for other entertainment and communications companies. Id. at 28.

Indeed, as set forth below, many regulated telecommunications firms were bought and sold at multiples of book value. The courts held that this additional amount of value over book must be considered in setting rates.

> The decisions of this Court declare: 'That there is an element of value in an assembled and established plant, doing business and earning money, over one not thus advanced, is self-evident. This element of value is a property right, and should be considered in determining the value of the property, upon which the owner has a right to make a fair return when the same is privately owned although dedicated to public use.'

McCardle v. Indianapolis Water Co., 272 U.S. 400, 414 (1926). Only by recognizing now that the economic valuation of firms may legitimately exceed book value can the Commission properly establish an appropriate cable television system ratebase.

C. Values In Excess Of Book Reflect Losses Sustained In Early Years Or Generations

These "premiums" also are appropriate in the cable industry given the nature of the business. As noted in the NPRM, cable systems are in many senses "start-up" enterprises that cannot be expected to earn enough to cover expenses and a reasonable return on invested capital in the early years.[32/] As a result, when a cable system is sold, the owner will demand to receive, as

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32/ NPRM ¶ 49.

part of the purchase price, a return on his original investment, including not only actual operating losses, but below-par earnings from earlier years as well.[33/] Indeed, the premiums over book for transactions in 1988-1990 show that the range for cable acquisitions are within the range for other related companies.[34/]

For these reasons, the entire purchase price paid for a cable system must presumptively be viewed as legitimately included in rate base for cost-of-service purposes. Failure to do so would amount to a simple confiscation of the capital legitimately and reasonably invested in those enterprises by their current owners. It follows that the Commission may not lawfully set cable subscriber rates at levels so low that they do not accurately reflect reasonable earnings on current owners' entire purchase price for a system.

These same considerations illustrate that, even under cost-of-service principles, cable rate increases that are substantially above the rate of inflation would often be fully justified, whether the systems are newly acquired or not. Table 1

33/ Broad industry groups such as the S&P Industrials are not composed of "start-up" companies, so amortization of early losses and sub-standard earnings would not generally be a factor justifying a premium over book value for these firms. As a result, cable properties -- which are "start-ups" -- can logically be expected to sell for an even higher multiple of book value than the 3.2 figure applicable to the S&P Industrials. AUS Report at 37-38

34/ AUS Report at 29.

in Exhibit D shows a calculation of the reasonable rates for a hypothetical cable system which is purchased after its fifth year of operations for $1.79 million, with a fair market value of its physical plant of $1.0 million and subscriber rates of $25.00 per month.

Under these circumstances, to earn a "reasonable" pre-tax return of only 15% would require an immediate 28% rate increase, to $32.05 per month. Rates would need to increase again the next year by 3%, to $33.04, to allow reasonable earnings in light of expense inflation. Rates would stay above $31.00 per month for the next four years, and would not decline below $30.00 per month until the new owner had been operating the system for nearly a decade.35/

Table 2 shows what happens to rates if the rate increase in any year is limited to 12.5% -- well above the rate of inflation, but not sufficient to generate reasonable earnings levels for the cable operator in the first year. With this constraint, the cable system operator does not achieve reasonable earnings on this investment in any year for the first decade of system ownership, even though rates increase every year.

35/ The figures in the tables are based on the assumption that the capitalized losses and substandard earnings included in the new owners' purchase price are to be amortized over a 10-year period. They also assume that system operating expenses increase at a modest 4% level each year.

This analysis supports two key conclusions. First, it would be utterly arbitrary to limit rates set in cost-of-service hearings to the rates in existence at the time of the rate freeze in September 1992. Second, depending upon the particular circumstances of an individual system, significant rate increases may be appropriate under accepted cost-of-service principles to allow the system owner the opportunity to earn a reasonable return on his investment.

If ratebase valuation is premised on valuation of firms that operate in effectively competitive markets, the valuation will exclude monopoly rents residually. This is the premise which the Commission apparently sought to follow in establishing its benchmarks, although the limitations of the data are well known. There is, however, a reservoir of valuation information from competitive businesses which may be applied in establishing the cable rate base.[36/]

36/ The Commission must also be sure that rates do not run afoul of the First Amendment. While the government has inherent power to promote the general welfare, that power is limited by the First Amendment. Columbia Broadcasting Sys. v. Democratic Nat'l Comm., 412 U.S. 94, 104-06 (1973). Controlling what rates cable operators may set whether or not in furtherance of other generally accepted governmental notions, regulations will directly and substantially impact cable operators' decisions regarding the acquisition and production of programming and the manner in which such programming will be marketed. In this posture, rate regulations are directly related to the content and distribution of programming. The fact that the government is controlling cable operators' rates as opposed to a more direct restraint

[Footnote continued]

D. Excesses Over Book Reflect Separate And Distinct Valuable Intangibles

The initial valuation should be based on genuine economic analysis and historical perspective, and not be confined merely to accounting concepts like goodwill or intangibles. For example, general accounting rules require that the purchase price of an acquisition above the fair market value of identifiable net assets be recorded as goodwill.[37/] In most instances, there is little reason to further allocate goodwill into obvious components -- such as customer lists, franchise rights, etc. -- when any subdivision would have little meaning to the acquiring firm. Yet the accounting treatment of a purchase price as "goodwill" does not mean that the firm has no added economic value (and benefit to subscribers) as a going concern.[38/] "Goodwill" may not be dismissed as valueless "excess acquisition costs." Because a company's intangible resources often are what separates the

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[Footnote continued]

on program content, does not render the rate regulations immune from constitutional challenge. See Miami Herald Publishing Co. v. Tornillo, 418 U.S. 241, 256 (1974); see also City of Lakewood v. Plain Dealer, 486 U.S. 750, 759 (1988).

37/ See generally APB-16.

38/ "A good property has an intangible value or going concern value over and above the value of the component parts of the physical property ..." McCardle v. Indianapolis Water Co., 272 U.S. at 413.

company from the competition, it seems incomprehensible to remove from the balance sheet an item that results from an arm's length transaction. Such an item must have some future value, or the acquiring company would be throwing away valuable resources. What is important here is that the valuation is not of the "goodwill" itself, but the impact of this goodwill on cable's tangible assets. "It is also well to remember that it is virtually impossible to separate the basic value from the enhanced value bestowed upon them by operation of goodwill."[39/] The following chart notes many of the factors that go into the "goodwill" calculus.

39/ Sponseller, Goodwill: A Tangible or Intangible Rate-making Component?, Public Utilities Fortnightly, August 17, 1989, p. 47.

SUGGESTED FACTORS CONSTITUTING GOODWILL[40/]

Source: R.H. Nelson
"The Momentum Theory of Goodwill," The Accounting Review (October 1953)

1. Customer lists
2. Organization costs
3. Developmental costs
4. Trademarks, trade names and brands
5. Secret processes and formulas
6. Patents
7. Copyrights
8. Licenses
9. Franchises
10. Superior earning power

Source: G.R. Catlett and N.O. Olsen, Accounting for Goodwill, AICPA Accounting Research Study No. 10 (1968)

1. Superior management team
2. Outstanding sales manager or organization
3. Weakness in a competitor's management
4. Effective advertising
5. Secret manufacturing process
6. Good labor relations
7. Outstanding credit rating resulting from an established reputation for integrity, resulting in increased leverage at favorable interest rates
8. Top-flight training program for employees
9. High standing in a community through contribution to charitable activities and participation in civic activities by a company's officers
10. Unfavorable developments in a competitor's operations
11. Favorable association with another company
12. Strategic location
13. Discovery of talents or resources
14. Favorable tax conditions
15. Favorable government regulation

Source: M.G. Tearney
"Accounting for Goodwill: A Realistic Approach," Journal of Accountancy (July 1973
(Percentages refer to a sample of 209 New York Stock Exchange listing applications for 1969 that indicated the specific reason for the acquisition)

1. Accomplishing a particular market objective (9.8%)
2. Saving time in expanding into a new area (4.3%)
3. Acquiring management and technical skills (5.6%)
4. Achieving product diversification (40.1%)
5. Achieving integration (32.2%)

Source: H. Falk and L.A. Gordon, "Imperfect Markets and the Nature of Goodwill," Journal of Business Finance and Accounting (April 1977)

Factor A: Increasing short-run cashflows
- Production economies
- Raising more funds
- Cash reserves
- Low cost of funds
- Reducing inventory holding cost
- Avoiding transaction cost
- Tax benefits

Factor B: Stability
- Assurance of supply
- Reducing fluctuations
- Good government relations

Factor C: Human factor
- Managerial talent
- Good labor relations
- Good training programs
- Organizational structure
- Good public relations

Factor D: Exclusiveness
- Access to technology
- Brand name

40/ Michael Davis, Goodwill Accounting: Time For An Overhaul, 173 Journal of Accountancy 77 (June 1992).

Applying these concepts generally to the cable industry, intangibles have separate and discrete values.

1. **Subscriber Base**

The existence of a base of subscribers at the time of acquisition is one obvious component of an acquiring firm's intangible assets that has value to the firm and its customers. To gain these subscribers it would be necessary for the acquiring firm to conduct major marketing campaigns and place advertisements in the local media, in addition to simply making the cable connection and incurring the administrative costs associated with that connection. It is clear that the base of subscribers at the time of acquisition has value and should be reflected in rates.

One approach to the estimation of the value of an existing base of subscribers would be to determine the revenue from these customers over the period that they remain customers. Cable systems generally have attrition statistics that are relatively stable. These figures could be used to project the amount of basic revenue that can be expected from a given base of subscribers. These revenues discounted over a predefined number of years would yield an estimate of the value of an existing subscriber base.

Another approach would be to estimate the cost per subscriber associated with building a viable subscriber base. The

distinction between a subscriber base and a viable subscriber base is an important one. Because cable service is a contract, cancelable on short notice, one must take care when estimating the cost to acquire a new subscriber to only consider costs that will build a loyal base of customers. For instance, deep discounts on installation fees, or similar giveaways, may increase subscribership only temporarily and not yield a reliable figure. In any event, the value of an existing subscriber base is substantial and is a major component of what is commonly called "goodwill."

A rate base addition given the above approach could be easily calculated. For a hypothetical company, a rate base addition for the subscriber list portion of an intangible could be calculated using an initial base of subscribers of approximately 500,000, an aggressive 33% churn rate, and a conservative operating ratio of 40%,[41/] as follows:

41/ See Exhibit E (reprint of pages from Kagan Cable TV Financial Databook) at Table 2 pg. 61. The average operating ratio for publicly traded cable firms for 1991 was approximately 55%.

Calculation of the Intangible Asset
Related to an Initial Base of Subscribers
($000's)

	Customers									Cash Flow	Present Value
YR1	500,000	x	$20	x	12 mos.	x	40%	=		$48,000	$43,636
YR1	330,000	x	$20	x	12 mos.	x	40%	=		$31,680	$26,182
YR1	165,000	x	$20	x	12 mos.	x	40%	=		$48,000	$12,652
										$96,520	$82,470

The above figures yield a present value that should be added to rate base of approximately $82 million (assuming a 10% discount rate) representing the value to the firm and its customers of an existing base of subscribers. The above calculation is conservative in that it assumes that any benefits from the initial subscriber lists occur over only the first three years (an aggressive churn rate), yet the benefits and the recoupment of these initial operating losses will take many more years.

2. **Franchise Operating Rights**

The right to operate a cable television franchise has value separate and apart from any initial direct payments made to the franchising authority. The value of a franchise may be difficult to determine separately because franchise agreements are virtually never sold independently of operating cable systems. That difficulty, however, does not preclude a valuation of the franchise or its inclusion in rates.

One approach to estimating the value of a franchise agreement would be to consider the situation of an unbuilt

start-up system whose only asset is a franchise operating right. A cash flow analysis could be constructed given a range of terminal values for the enterprise at the end of the franchise term and the costs associated with building a cable system from the ground up. The present value difference between these two cash flows would be the value of the franchise operating right. While an approach is an estimate of the value of the franchise agreement, it does reveal the existence of an intangible asset.

Intuitively, there is inherent value to a franchise separate from the negotiated payments to a franchising authority for the transfer of the franchise rights, even though there is no market for such rights and their value is difficult to estimate.

3. Subscriber Growth

Another major component of the intangible assets of a cable television firm is the estimated growth in subscribers. In an industry with high fixed costs and low marginal costs there is obvious benefit to the company and to its current subscribers to increasing subscribership. Each added subscriber lowers the average cost for existing customers and increases profits to the firm. This simple relationship is clearly related to basic economies of scale and is separate and apart from any monopolistic intent to raise rate indiscriminately.

Regulatory determinations as to whether a transaction is prudent and reasonable must be made based on information available at the time the transaction or decision was made. Regulatory determinations cannot be based on hindsight review Thus, if the decision to purchase the cable system at a competitive price (see Section III(E)(1) infra) is reasonable, the piece of that purchase related to the then contemporaneous anticipation of subscriber growth also is a reasonable component and should be included in rates. (No recovery of the actual rate increase charged to those subscribers is reflected in this discussion on "subscriber growth", because of the abundant concern over "monopoly rates" in the NPRM, but some increase in rates over time consistent with inflation can hardly be judged monopoly driven).

It is clear from a careful review of current cable operators' actual purchases of cable systems, and documents upon which these purchases were based, that intangible assets are not related solely to expected monopoly profits. One component which is reflected in the intangible asset account is "subscriber growth" and can be easily computed.

Contemporaneous with the purchase of a cable system, the purchaser would have completed a financial analysis delineating expected revenue streams. After all, it was the expectation of running the business profitably that was the catalyst for culminating the transaction. That revenue stream would

have been composed of rates anticipated to be charged each expected subscriber. Given the then-current penetration levels of cable systems, growth in subscriber base was a reasonable expectation.

This assessment of growth in basic subscribers that could be attained by the acquiring firm would be made in light of the current penetration levels, an evaluation of current management, the amount of confidence in the new management, marketing skills, etc. This assessment of the increase in basic customers times an average rate for basic service, discounted would yield an appropriate value of anticipated future subscriber growth. To determine the appropriate component for intangible assets to include in rate base for "subscriber growth", the Commission should permit cable operators to include the analysis performed contemporaneously with the purchase of the system, now being regulated to illustrate the "reasonable expected subscriber growth" component of intangible assets.

An analysis can be made for a hypothetical company as to the reasonable amount of growth that could be achieved in basic subscribers through aggressive marketing campaigns, improved programming and service, improved reception, and the like. We assume growth is expected to be 7% declining to approximately 3% over the first ten years of new ownership. Given an initial base of basic subscribers of approximately 500,000, the

annual growth in subscribers would be expected to average 30,000 (500,000 * .06). Assuming an average rate of $20/month this translates into approximately $7.2 million per year. This, in turn, translates into over $40 million on a present value basis (10 yrs. at 10%). The above calculation is conservative in that it excludes any anticipated rate increases, is net of any subscriber churn, and excludes anticipated subscriber growth in nonregulated services and prices. In the above instance, the $40 million is appropriately included in rate base as a portion of intangible assets of the firm.[42/] To the extent cable operators can provide similar material to show the reasonableness of the subscriber growth component of excess acquisition costs, rate base should be adjusted.

4. Other Intangibles

Goodwill forms the major component of the assets of many cable television systems. From the above discussion it is clear that this value is substantial and clearly distinguishable from any monopolistic intent. The example of a start-up cable firm that has no employees, subscribers, or franchises is a good example of how a cable company is worth much more to cable subscribers and the owners of a firm than the sum of identifiable tangible net assets. It is properly characterized as "going concern" value.

42/ Using subscriber growth as an "add-on" to the benchmarks is discussed in Section 6, infra.